1997

New Tax Law And You : Planning For 1997 & 1998 : A CPA's Guide For Taxpayers

American Institute of Certified Public Accountants (AICPA)

The New Tax Laws and You: Planning for 1997 and 1998

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A CPA's Guide for Taxpayers

INTRODUCTION

Figuring out your yearly tax bill can be daunting, and with the avalanche of tax changes made by The 1997 Taxpayer Relief Act, it can seem even tougher. With some advance planning though, you can make even the most complex tax law changes work for you. Here are some of important changes made by the new laws that may affect your 1997 tax bill, as well as some planning ideas for 1998 and future years.

THE NEW TAX LAW & YOUR 1997 TAXES

Selling Your Home. Taxpayers can now exclude from federal income tax the capital gains from the sale of their home, up to $500,000 for married couples filing jointly, and up to $250,000 for a single person. To be eligible, you have to have owned and occupied a home as a principal residence for at least two of the five years before the sale. The new rules were made effective retroactively to May 7, 1997. The new law will allow most families to sell their home as often as every two years, without paying capital gains tax, and will reduce the record-keeping hassles of noting what you spent in home improvements, to show what is gain and what is not.

Gone however, is the deferral of capital gains on the sale of a home by rolling the gains into a home of equal or greater value within a certain period of time. Gone also is the one-time exclusion of up to $125,000 on capital gains from the sale of a principal residence for taxpayers who reached the age of 55 before the sale.

What to do if you bought a new house this summer? Taxpayers who purchased, or were in a binding contract to purchase, a replacement residence after May 6, 1997, and before August 5, 1997, can choose to rollover the gain under the old rules, or to be treated under the new rules.

Figuring Your Capital Gains Tax. The top capital gains rate for individuals has been reduced to 20% from 28%, effective retroactively to May 7, 1997. For capital assets bought after the year 2000 and held more than five years, the new top rate is 18%. For those in the 15% tax bracket (couples whose adjusted gross income, AGI, is below $41,200), the new rates are 8% for long-term capital assets, and 10% for short-term assets. The holding period for an asset to qualify for long-term capital gains treatment has been increased from more than 12 months to more than 18 months, effective July 29, 1997. For assets held between 1 year and 18 months, the present maximum rate of 28% will be applied, also effective July 29, 1997.

How long is long enough? The lower capital gains rate took effect May 7, 1997, but the long-term holding period of 18 months applies to assets sold after July 29, 1997. This means that for assets sold between May 7 and July 29 of 1997, they will qualify for the new 20% capital gains rate if, on the date of sale, they had been held for at least 12 months.

Rethinking Your Retirement Plans. In 1996, the 15% excise tax on "excess distributions," was suspended on various types of retirement plans and annuities. An excess distribution was any amount that went over a certain threshold ($160,000 in 1997). But, the 15% estate tax on excess retirement accumulations made after a person's death was still in effect. This year's tax act repeals both the 15% excise and estate taxes, effective for excess distributions received after December 31, 1996, and for the estates of decedents dying after December 31, 1996.

Donating Appreciated Stock to Charity. The special rule that permits a person who donates appreciated stock to a private foundation to deduct the fair-market value of the stock expired this year on May 31, 1997. This rule has been extended retroactively from June 1, 1997 through June 30, 1998.

Using State Tuition Programs. In 1996, tax-exempt status and a deferral of tax on earnings was given to qualified state tuition programs for post secondary education. Now, costs include not only tuition, fees, books and supplies, but room and board expenses.

TAX PLANNING FOR 1998

The 1997 Taxpayer Relief Act made dozens of changes that don't apply to the 1997 tax year, but are important to keep in mind as you plan for 1998 and future years.

Individuals & Families

Child Tax Credit. The new tax law provides a $400 child tax credit for the 1998 tax year, and $500 in 1999 and later years, for each qualifying child of a taxpayer. A qualifying child must be under 17, must be an individual for whom the taxpayer can claim a dependency exemption, and must be a son, daughter, or direct descendant of the taxpayer, or a stepson, stepdaughter, or eligible foster child of the taxpayer. The credit gets reduced by $50 for each $1,000 of modified AGI over a certain threshold. For married taxpayers filing joint returns, the threshold is $110,000; for taxpayers filing single or head of household returns, it is $75,000; and for married taxpayers filing separate returns, it is $55,000.

Dependent Deduction Increased. The standard deduction for a dependent has been increased for tax years beginning after December 31, 1997. Under the old law, the basic standard deduction for an individual who could be claimed as a dependent by another taxpayer was limited to the greater of $500 or the individual's earned income, but not more than the basic standard deduction amount ($4,150 in 1997). The new law increases the amount, so the standard deduction will be the greater of: 1) $500, or 2) the individual's earned income plus $250, but again, it can't be more than the basic standard deduction amount for the individual. The $500 will continue to be adjusted for inflation (in 1998 it is expected to be $700), and the $250 amount will be indexed for inflation after 1998.

Estimated Tax For Individuals. The minimum threshold amount for estimated tax payments has been increased from $500 to $1,000. This means that if you underpay your estimated taxes, you won't be hit with a penalty if the total tax amount due for the year, reduced by any withheld tax, is less than $1,000. This is effective for tax years beginning after December 31, 1997.

Home Office Deduction. The new law makes it easier for taxpayers to take the home office deduction, by expanding the definition of "principal place of business. " It now includes a home office that is used by the taxpayer to conduct administrative or management activities of a business, if there is no other fixed location where the taxpayer can do so. But, it doesn't change the requirement that deductions are allowed for a home office only if the taxpayer uses the office *exclusively* on a regular basis as a place of business, and, in the case of an employee, the exclusive use is for the convenience of the employer. Taxpayers won't benefit from this new definition until 1999, since it is effective for tax years beginning after December 31, 1998.

Health Deduction For Self-Employed. The cost of health insurance for self-employed individuals will become 100% deductible. The deduction will be phased in over the next several years; in 1997, the deduction is 40. For 1998 and 1999, the deduction will be 45% and eventually reach 100% in the year 2007.

Retirement Planning

New Type Of IRA Created. A new type of tax-free, non-deductible IRA was created, called a "Roth IRA" (named after Senator Roth). This type of IRA allows taxpayers to put money away, and although the contributions can't be deducted, any earnings on the account are tax-free. In addition, the money is not taxed when withdrawn, as long as the withdrawal is made more than 5 years after the IRA has been established and is made on or after age 59 1/2, or on or after death or disability, or for first-time home buyer expenses (up to $10,000). This IRA's availability starts phasing out for individuals with AGI over $95,000 and for married couples with AGI over $150,000.

IRA Deduction Limit Increased. Previously, taxpayers with employer-sponsored pension or retirement plans were severely restricted in how they could deduct their IRA contributions on their tax returns. Joint filers with pension plans had to have an AGI of less than $40,000 to deduct their full IRA contributions. Single filers had to have AGI of less than $25,000 to deduct their full IRA contributions. Starting in 1998, the income ranges over which the $2,000 IRA deduction limit is phased out will be gradually increased. For 1998, the income ranges will start at $50,000 for joint returns and $30,000 for single filers.

The new law also changes the deduction limits for spouses of individuals who are in an employer-sponsored retirement plan. Under the old law, even if only one spouse was in a pension or retirement plan, both spouses were subject to strict deductibility limits for IRA contributions. Now, one spouse can deduct his or her account contributions, without an employer contribution plan, even if the other spouse participates in a retirement plan. The deduction phases out for taxpayers with AGI of more than $150,000.

Penalty-free Withdrawals For All IRAs. Beginning in 1998, penalty-free withdrawals from any type of IRA will be allowed for first-time home buyer expenses (up to $10,000) and higher education expenses.

Estate Planning

Increased Exemption Amount. Prior to the 1997 Taxpayer Relief Act, the estate of each taxpayer received an exemption of $600,000, thus making estates valued at less than $600,000 exempt from estate taxes. Estates over this amount were taxed at rates ranging from 37% to 55% on amounts over $600,000. Under the new law, the exemption amount will increase to $1 million by the year 2006. The exemption amount will be $625,000 in 1998.

New Exemption For Family Businesses. Previously, there was no exemption for family-run businesses; only the $600,000 individual unified credit exemption was available. Under the new tax law, effective in 1998, when more than 50% of the estate is comprised of a family-owned business and/or farm, the amount exempt from estate taxes will be $1.3 million (inclusive of the unified credit exemption).

Higher Education

Hope Scholarship Credit. Individual taxpayers are allowed to claim a nonrefundable credit against federal income taxes, up to $1,500 per student, per year, for qualified tuition and fees paid during the year on behalf of a student; a student can be the taxpayer, the taxpayer's spouse, or a dependent, and must be enrolled in a post secondary degree or certificate program at an eligible institution, on at least a half-time basis. The credit is computed per student, for each eligible student in the taxpayer's family for the first two years of undergraduate education. This credit phases out for taxpayers filing singly with modified AGI between $40,000-$50,000, and $80,000-$100,000 for joint returns. The Hope credit is available for expenses paid after December 31, 1997, for academic periods starting after that date.

Lifetime Learning Credit. Individual taxpayers are allowed to claim this credit against federal income taxes equal to 20% of qualified tuition and fees paid during the tax year on behalf of the taxpayer, the taxpayer's spouse, or a dependent. The maximum credit is $1,000 per year, per taxpayer; after 2005 it will increase to $2,000 per taxpayer, per year. The student must be enrolled at an eligible education institution. The student is eligible for the credit so long as he or she is taking undergraduate or graduate level classes at a qualifying institution, to acquire or improve job skills. This credit is computed on a per taxpayer return basis, so it doesn't vary based on the number of students in a taxpayer's family, and it may be claimed for an unlimited number of tax years. This credit phases out for single taxpayers with modified AGI between $40,000-$50,000, and $80,000-$100,000 for joint returns. The Lifetime Learning credit is available for expenses paid after June 30, 1998, for academic periods beginning after that date.

Education IRAs. Beginning January 1, 1998, taxpayers will be able to establish education IRAs. These IRAs must be created exclusively to pay the qualified higher education expenses of a named beneficiary, such as a child or grandchild. Generally, the earnings on the funds in the IRA won't be taxed until a distribution from the IRA is made, and distributions from the IRA won't be included in gross income. But, the annual contribution can't be more than $500 per beneficiary, and can't be made after the beneficiary reaches 18. And, you can't contribute to an education IRA in the same year in which you contribute to a qualified state tuition program on behalf of the same beneficiary. Eligibility for education IRAs phases out for single taxpayers with modified AGI between $95,000-$110,000, and between $150,000-$160,000 for joint returns.

Note: Of the three methods above, you can only elect one for each student in any given year.

Student Loan Interest Deduction. Interest on qualified education loans may be claimed as an above-the-line deduction, up to a maximum amount of $2,500 a year, for any loan interest payment due for the first five years of the loan payment and paid after December 31, 1997. The maximum amount will be phased in over four years, beginning with $1,000 in 1998. The deduction phases out for single taxpayers with modified AGI of $40,000-$55,000 and for those filing joint returns, with modified AGI of $60,000-$75,000.

Penalty-Free IRA Withdrawals. Beginning January 1, 1998, penalty-free withdrawals can be made from IRAs for qualified higher education expenses, including those for graduate level courses. The withdrawal has to be for academic periods starting on or after January 1, 1998. The expenses can be of the taxpayer, the taxpayer's spouse, a child, or a grandchild of the individual or of the individual's spouse. Although there are no income phase-out ranges, the income limits for contributions to IRAs still apply.

Here To Serve You. To make sure you're taking full advantage of the tax laws, talk to a CPA. CPAs are well-versed in the latest tax developments and planning strategies that can help you minimize your tax burden.

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go back